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# A Newly Identified Contract Unconscionability: Unconscionability of Remedy

M. N. Kniffin\*

## I. Introduction

Should a court limit foreseeable contract damages that amount to one hundred times the contract price?<sup>1</sup> An innovative<sup>2</sup> section of the *Restatement (Second) of Contracts*, 351(3),<sup>3</sup> permits courts to limit foreseeable contract damages that are disproportionately large in comparison with the consideration received by the breaching party. This article explores the likelihood that the novelty of section 351(3) lies principally in its openness in labeling and elucidating a concept that has been evolving in common and statutory law over considerable time.

On rare occasions before the adoption of section 351(3) and as early as 1864, courts candidly declared that their ground for limiting consequential damages was disproportion or the failure to allocate risk, which is the usual cause of disproportion.<sup>4</sup> More frequently, however, limitation of disproportionate damages has been accomplished covertly, by invoking requirements of foreseeability, certainty, and mitigation.<sup>5</sup> Judge Learned Hand observed in 1947 that foreseeability is "a fictitious standard."<sup>6</sup> Fuller and Perdue noted in 1936 that the foreseeability requirement "is less a definite test itself than a cover for a developing set of tests."<sup>7</sup> Beginning at least five decades ago, commentators<sup>8</sup> have noted

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1 An unusual fact situation is posed here in order to encourage those readers who may believe that all foreseeable damages should always be awarded regardless of the amount of consideration received by the breaching party to reconsider whether under certain occasionally occurring circumstances it may be fairer to impose some limit on these damages.

2 See Harvey, *Discretionary Justice Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 666, 667 (1982).

3 RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1981) (hereinafter RESTATEMENT SECOND) provides:

A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.

4 See, e.g., *Rochester Lantern Co. v. Stiles & Parker Press Co.*, 135 N.Y. 209, 218, 31 N.E. 1018, 1021 (1892); *Kenford Co. v. Co. of Erie*, 108 A.D.2d 132, 148-55, 489 N.Y.S.2d 939, 951-6 (1985) (Hancock, J., dissenting), *aff'd.*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986); *Fleming v. Beck*, 48 Pa. 309, 312 (1864).

5 See, e.g., *Stanley v. Tinsman*, 159 Me. 17, 18-21, 187 A.2d 401, 403-04 (1963); *Seaman v. United States Steel Corp.*, 166 N.J. Super. 467, 475, 400 A.2d 90, 94 (1979); *Kenford Co. v. Co. of Erie*, 67 N.Y.2d 257, 262, 493 N.E.2d 234, 236, 502 N.Y.S.2d 131, 133 (1986); *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854); Uniform Commercial Code (hereinafter U.C.C.) §§ 1-205, 2-208, 2-715(2)(a) (1977).

6 *Stamford Extract Mfg. Co. v. Oakes Mfg. Co.*, 9 F.2d 301, 303 (2d Cir. 1925).

7 Fuller & Perdue, *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52, 85 (1936).

8 See J. CALAMARI & J. PERILLO, *CONTRACTS* § 14-8, at 601 (3d ed. 1987) ("[T]he standard of certainty, like the level of foreseeability, is based at least partly upon a policy of limiting contractual

the judiciary's disguised use of these rules in order to limit imposition of risk or otherwise avert extreme unfairness of remedy. Some of these commentators have urged that courts address the problem more frankly.<sup>9</sup>

The overt use of disproportion as a ground for limiting damages, in order to avoid extreme unfairness, can be called unconscionability of remedy.<sup>10</sup> Section 351(3) may signal development of a concept parallel to or even synonymous with substantive and procedural unconscionability. Courts and legislatures have expressly declared that contracts or contract terms are unenforceable when highly unfair, either in their content (substantive unconscionability<sup>11</sup>) or in the process by which agreement was reached (procedural unconscionability<sup>12</sup>). Both the Uniform Commercial Code and the *Restatement (Second) of Contracts* ("*Restatement Second*") expressly state that the goal of refusing or limiting enforcement of unconscionable contracts or contract terms is "to avoid any unconscionable result."<sup>13</sup> This decisional process contrasts with earlier, more traditional reasoning which was less overt, such as a declaration of lack of consideration when, technically, consideration did exist but the contract

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risks."); D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 12.3, 803-17 (1973) ("*Hadley* and 'foreseeability have become conventions for the expression of results derived on other grounds altogether.'" *Id.* at 810.); E. FARNSWORTH, *CONTRACTS* § 12.17, at 892-93 (1982) ("Courts have covertly expressed their reluctance [to impose disproportionately large liability] by so applying the test of foreseeability as to find that what was foreseeable becomes unforeseeable. They have also shown their reluctance by a particularly rigorous application of the requirement of certainty."); C. MCCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* 569-75 (1935) (The author refers to the "general standard of foreseeability . . . by which judges can prevent or overturn the allowance by juries of claims [for] . . . losses thought by the judges to be unjust or disproportionate." *Id.* at 565.); J. MURRAY, *MURRAY ON CONTRACTS* § 226, at 456 (2d rev. ed. 1974); Fuller & Perdue, *supra* note 7, at 84-88 ("[T]here is much reason to suspect that courts are influenced by factors which have nothing to do with foreseeability. Particularly apparent is an impulse to preserve some proportion between the liability imposed on the defendant and the compensation which was paid him under the contract." *Id.* at 88); Ricks, *A Comparison of the Scope of Contract Damages in the United States and Japan*, 12 INT. LAW. 105, 127-28 (1978); Stone, *Recovery of Consequential Damages for Product Recall Expenditures*, 1980 B.Y.U. L. REV. 485, 485 (1980); Comment, *Lost Profits as Contract Damages: Problems of Proof and Limitations on Recovery*, 65 YALE L.J. 992, 1020 (1956) ("[T]he courts have attempted to restrict unduly large verdicts by denying compensation unless [the foreseeability requirement is satisfied].").

9 See Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 283 (1975); Simon & Novack, *Limiting the Buyer's Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts*, 92 HARV. L. REV. 1395, 1427 (1979) ("If flexibility is to be applied to breach of contract awards, fairness and predictability would suggest that it be done overtly rather than covertly."); Stone, *supra* note 8, at 532. Commentators who have urged that courts identify failure to allocate risk as the reason for limiting consequential damages include 5 A. CORBIN, *CONTRACTS* § 1010, at 81-82 (1964); and Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1209-10 (1970). In Harvey, *supra* note 2, at 671, the author expresses general approval of the use of greater judicial candor in limiting contract damages. Approval of disproportion as a criterion for limiting contract damages is indicated in Comment, *supra* note 8, at 995-96.

10 For example, the awarding of "unconscionable and grossly oppressive damages, contrary to substantial justice" is proscribed by an Oklahoma statute which requires that damages "in all cases, be reasonable." OKLA. STAT. ANN. tit. 23, § 97 (1986).

11 *E.g.*, Graham v. Scissor-Tail, 28 Cal. 3d 807, 623 P.2d 165, 171 Cal. Rptr. 604 (1981); American Home Improvement v. MacIver, 105 N.H. 435, 201 A.2d 886 (1964) (alternative holding); Jones v. Star Credit Corp., 59 Misc. 2d 189, 298 N.Y.S.2d 264 (1969); Frostifresh Corp. v. Reynoso, 52 Misc. 2d 26, 274 N.Y.S.2d 757 (1966); U.C.C. § 2-302.

12 *E.g.*, Weaver v. American Oil Co., 257 Ind. 458, 276 N.E.2d 144 (1971); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973), *cert. denied*, 415 U.S. 920 (1974); Brooklyn Union Gas Co. v. Jimenez, 82 Misc. 2d 948, 371 N.Y.S.2d 289 (1975).

13 U.C.C. § 2-302; RESTATEMENT SECOND, *supra* note 3, § 208.

terms were so extremely unfair as to impel a court to refuse enforcement.<sup>14</sup> So, too, with remedies, courts have limited contract damages by invoking traditional rules such as foreseeability, certainty, and mitigation of loss when the real or at least principal motivation of the court was prevention of extreme unfairness. In contrast, section 351(3) permits a court candidly to limit damages for foreseeable loss when "justice so requires in order to avoid disproportionate compensation."<sup>15</sup> The term "disproportionate" implies a high degree of unfairness, commensurate with that denominated substantively or procedurally unconscionable by courts,<sup>16</sup> legislatures,<sup>17</sup> and the *Restatement Second*.<sup>18</sup> It describes a difference much greater than mere disparity.<sup>19</sup>

Just as a court can refuse to enforce, for procedural unconscionability, a contract to purchase a gas burner signed by a Spanish-speaking consumer who could neither read nor speak English and had not been told the terms of the document,<sup>20</sup> so can a court refuse to grant consequential damages of \$10,000 for foreseeable crop failure when a promised \$100 tractor light is not delivered and the seller foresaw that no substitute would be available.<sup>21</sup>

Just as substantive and procedural unconscionability are determined with respect to the time of the making of the contract,<sup>22</sup> so do section 351(3) and unconscionability of remedy relate to that time. The disproportion concerned is that of consideration promised at the time the contract was entered, compared with risk of much larger liability, which the parties failed to allocate to the breaching promisor when the contract was entered.

Limiting damages in accordance with unconscionability of remedy and with section 351(3) can be less extreme in one respect than refusal to enforce a substantively or procedurally unconscionable contract, because here a remedy is usually not refused.<sup>23</sup> It is merely curtailed, in keeping with the same underlying goal of fairness that motivated development of the rules of substantive and procedural unconscionability.

14 In *Newman & Snell's State Bank v. Hunter*, 243 Mich. 331, 220 N.W. 665 (1928), the court refused on the ground of lack of consideration to enforce a widow's promise to pay her deceased husband's debt to a bank which had, in exchange, returned to her the promissory note signed by her deceased husband and the shares of stock that secured it. Although the husband's note and the shares probably had no monetary value because both his estate and the corporation in which the shares were issued were insolvent, the court could have concluded that the widow bargained for and received a performance which cleared her husband's name and thus benefitted her. In 1928, bankruptcy undoubtedly entailed greater social stigma than it does today.

15 *RESTATEMENT SECOND*, *supra* note 3, § 351(3). See also *supra* note 3 for the language of § 351(3).

16 See, e.g., cases cited *supra* notes 11 and 12.

17 See, e.g., U.C.C. § 2-302.

18 *RESTATEMENT SECOND*, *supra* note 3, § 208.

19 The Comment to § 351(3) refers to "extreme disproportion." See *infra* note 50.

20 *Brooklyn Union Gas Co. v. Jimenez*, 82 Misc. 2d 948, 371 N.Y.S.2d 289 (1975).

21 This hypothetical fact pattern resembles that presented in *RESTATEMENT SECOND*, *supra* note 3, § 351(3), comment f, illustration 18. It is discussed also at *infra* text accompanying notes 67-69, 78, 112, and following note 77.

22 See, e.g., U.C.C. § 2-302.

23 Although U.C.C. § 2-302 permits judicial refusal to enforce a contract, it also authorizes refusal to enforce a contract term, as well as limitation of the application of a term.

This article first examines the scope of section 351(3). Next, it compares the existing case and statutory law with both section 351(3) and the concept of unconscionability of remedy, to reveal the extent to which all of these correspond. Finally, it evaluates section 351(3) and explores whether alternatives and supplements to the section also could achieve its perceived purpose, that of curbing unconscionability of remedy.

## II. Scope of Section 351(3)

### A. *Context of Section 351(3)*

Antecedent to a decision to limit expectation damages in any manner is an assumption that expectation damages should usually be awarded; that is, that the aggrieved party should be placed so far as possible in the position he would have occupied had the contract been performed. This assumption is by no means irrefutable. Fuller and Perdue observed that justice does not necessarily require fulfilling the aggrieved party's expectation<sup>24</sup> and may instead require only returning him to his previous economic situation by awarding reliance damages.<sup>25</sup> Furthermore, these writers noted that the restitution interest, that of restoring unjust enrichment to the party at whose expense it was gained, exerts an even more pressing claim than does the reliance interest.<sup>26</sup> They concluded, however, that significant goals of society are achieved by fulfilling the expectation interest: breach is deterred and people are thereby encouraged to contract; efficient allocation of labor and goods is accomplished and the transaction of business is thus facilitated.<sup>27</sup> Corbin, too, saw the need to deter breach by awarding contract damages, in order to enable the nation's system of credit to function.<sup>28</sup> Williston favored fulfilling the expectation interest of an aggrieved party.<sup>29</sup>

Even when damages for the expectation interest are awarded, courts have declined to compensate for every possible loss attributable directly or indirectly<sup>30</sup> to the breach. Modes of limitation include the foreseeability requirement. Motives for imposing limitation include fairness, as well as stability and predictability in commercial transactions and avoidance

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24 Fuller & Perdue, *supra* note 7, at 56-57.

25 *Id.* at 56.

26 *Id.*

27 *Id.* at 61-62.

28 CORBIN, *supra* note 9, § 1002, at 34.

29 3 WILLISTON, CONTRACTS § 1338 (1920) (cited by Fuller & Perdue, *supra* note 7, at 52-53).

30 The extent of such harm is suggested in George Herbert's 1651 description of the losses that resulted from lack of a horseshoe nail: "For want of a nail the shoe is lost, for want of a shoe the horse is lost." G. HERBERT, JACULA PRUDENTUM (1651), cited in J. BARTLETT, FAMILIAR QUOTATIONS 270 (15th ed. 1980).

of deterring willingness to contract.<sup>31</sup> Corbin referred to the flexibility to be found in rules for determining contract damages.<sup>32</sup>

### B. *Types of Loss Encompassed*

Section 351(3) imposes a further limitation on damages that have initially been limited by the foreseeability requirement established in *Hadley v. Baxendale*<sup>33</sup> and promulgated in case law,<sup>34</sup> the Uniform Commercial Code,<sup>35</sup> and the *Restatement Second*.<sup>36</sup> The opening phrase of section 351(3) states that "[a] court may limit damages for foreseeable loss."<sup>37</sup> Rarely has the scope of section 351(3) been interpreted as encompassing general damages, which are based on the market value<sup>38</sup> of the promised performance, as distinguished from consequential<sup>39</sup> damages that result indirectly from failure to perform and to which the section clearly applies. It has been suggested, however, that the language permits this reading.<sup>40</sup> Judicial citations of section 351(3) to date have concerned only consequential damages.<sup>41</sup> Probably a principal reason why an inter-

31 See discussion of judicial motives in R. BYRN, *CASES AND MATERIALS ON REMEDIES II* 61 (3d ed. 1984) (concerning "stability and predictability in commercial transactions"); DOBBS, *supra* note 8, § 12.3, at 804 ("The broad principle that contract damages, like tort damages, must somehow be limited, is one of major significance."); McCORMICK, *supra* note 8, at 574 (1935) (Limitation is imposed "whenever such recovery seems unjust or unduly burdensome to business enterprise."); MURRAY, *supra* note 8, § 224, at 450; Danzig, *supra* note 9, at 263-65; Ricks, *supra* note 8, at 107; Vernon, *Expectancy Damages for Breach of Contract: A Primer and Critique*, 1976 WASH. U. L.Q. 179, 203 (1976) ("If damages are too high . . . parties might be deterred from entering contracts at all."); Comment, *supra* note 8, at 995-96.

32 CORBIN, *supra* note 9, § 1002, at 33.

33 156 Eng. Rep. 145 (1854).

34 See, e.g., *Spang Indus., Inc. v. Aetna Cas. & Sur. Co.*, 512 F.2d 365 (2d Cir. 1975); *Kerr S.S. Co. v. Radio Corp. of Am.*, 245 N.Y. 284, 157 N.E. 140 (1927) (Cardozo, C. J.).

35 U.C.C. § 2-715(2)(a).

36 RESTATEMENT SECOND, *supra* note 3, § 351(1) & (2).

37 *Id.* at § 351(3). See *supra* note 3.

38 When no market exists, courts employ other methods of determining the value of the promised performance, such as rental or use value. General damages are also referred to as "direct" damages. See *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 955 (7th Cir. 1982) (Posner, J.), *cert. denied*, 459 U.S. 1017 (1982); Fuller & Perdue, *supra* note 7, at 83.

39 Consequential damages are also referred to as "special" damages. See *Evra Corp.*, 673 F.2d at 955; Fuller & Perdue, *supra* note 7, at 83.

40 See Harvey, *supra* note 2, at 668-69, 679.

41 Section 351(3) has been cited by the Supreme Court of Alaska, which remanded, requesting that the trial court "reconsider its award of damages in light of Restatement (Second) of Contracts § 351(3). . . ." *N. Alaskan R. & Pest Co. v. United Bank Alaska*, 685 P.2d 1211, 1222 n.6 (Alaska 1984). Section 351(3) was cited also by an intermediate Arizona court, which decided that no disproportion existed. *All Points Towing, Inc. v. City of Glendale*, 153 Ariz. 115, —, 735 P.2d 145, 148 (1987). Concurring in part and dissenting in part, two judges of a New York intermediate court stated that the rationale for the majority's limiting of "excessive and disproportionate" damages should have been § 351(3). *Kenford Co. v. Co. of Erie*, 108 A.D.2d 132, 148, 153, 489 N.Y.S.2d 939, 952, 955 (1985) (Hancock, J., dissenting), *aff'd*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986). They pointed out also that the contract was not commercial in nature and noted that the Comment to § 351(3) explains that the likelihood that the section will be applied is greater in such a context. *Id.* at 153 n.8, 489 N.Y.S.2d at 955 n.8. The majority stated that § 351(3), if it were adopted, would not be applicable because of lack of the requisite extreme disproportion. *Id.* at 137 n.5, 489 N.Y.S.2d at 944 n.5. Courts may not move rapidly to adopt § 351(3) because they are accustomed to employing instead the rules of foreseeability, certainty, and mitigation. In addition, because precedent existed for identifying disproportion as a criterion for limiting damages before the advent of § 351(3), courts in the future may follow such precedent without citing the section. Furthermore, relatively few cases of extreme disproportion of foreseeable damages occur, probably

pretation that includes general damages has not occurred to most readers is the placement of the subsection within the general scheme of the *Restatement Second*. The subsection is included in the section entitled "Unforeseeability and Related Limitations on Damages," and it follows two subsections that appear to concern only consequential damages because they concern foreseeability. In addition, the initial phrase of subsection three refers to "damages for foreseeable loss." Testing for foreseeability of loss is usually done with respect only to consequential<sup>42</sup> and not to general damages; the losses for which general damages compensate are usually assumed to be foreseeable, because a reasonable person knows upon entering a contract that if he fails to perform, the other party will be entitled to the cost above the contract price of procuring substitute performance. The breaching party will not necessarily foresee the losses for which consequential damages compensate, however; this fact has occasioned the threshold test of foreseeability.<sup>43</sup>

The argument for exclusion of general damages from coverage by section 351(3) is deflected somewhat by the third illustration in the Comment to the subsection.<sup>44</sup> This illustration is a hypothetical case in which a patient is refused general damages that would comprise the difference between the improved-looking nose promised her by a plastic surgeon and the value of her nose following surgery.<sup>45</sup> Although the limitation is imposed upon what would have been general damages, the illustration as well as the actual case upon which it is based<sup>46</sup> occur in a noncommercial context. This fact may indicate that general damages are touched upon by section 351(3) in only a tangential manner and are not covered by the section when a typical market transaction, such as sale of goods, is concerned. Nevertheless, since the point has been raised, this article will include discussion, when appropriate, of how general damage claims can be affected by section 351(3).

It is possible to argue also that section 351(3) encompasses disproportion of liability, not only in comparison with consideration received by the breaching party, but also in comparison with the seriousness of the breach. The latter interpretation would include cases in which a material, though not complete, failure to perform could deprive the breach-

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because when loss of such disproportionate magnitude is foreseeable, reasonable parties decline to contract, they adopt contract terms limiting liability, or they procure insurance.

42 See McCORMICK, *supra* note 8, at 571; but see Vernon, *supra* note 31, at 206.

43 It is possible that, although general damages are foreseeable as to type, they may be unforeseeable as to size; for example, an unanticipated, drastic change in market price may occur after formation of the contract. Yet the requirement of foreseeability has usually been interpreted to concern only type of damage. One writer has suggested that fairness may require courts to limit not only damages unforeseeable as to type but also those unforeseeable as to size. See Danzig, *supra* note 9, at 283. See also *infra* text accompanying note 178. The same author has written that fairness may mandate assessing foreseeability at the time of breach rather than at the time of formation of the contract. *Id.* See also C. KNAPP & N. CRYSTAL, *PROBLEMS IN CONTRACT LAW: CASES AND MATERIALS* 803 (2d ed. 1987).

44 RESTATEMENT SECOND, *supra* note 3, § 351, comment f, illustration 19. The other two illustrations to comment f do concern consequential damages.

45 She is given, however, reliance and restitution damages.

46 Sullivan v. O'Connor, 363 Mass. 579, 296 N.E.2d 183 (1973). See Reporter's Note to comment f to § 351.

ing party of receipt of further performance.<sup>47</sup> In addition, this interpretation would embrace cases in which failure to fulfill an express condition renders the breaching party vulnerable to loss of all further performance.<sup>48</sup> It is highly unlikely that the American Law Institute intended section 351(3) to apply when potential liability is disproportionate to seriousness of breach, in view of its probable lack of relevance to other than consequential damages.<sup>49</sup> Furthermore, the Comment,<sup>50</sup> in referring to disproportion, describes disproportion of liability with respect only to consideration and not with respect to nature of breach. As will be discussed in Part IV below, however, the concept of unconscionability of remedy can encompass these other situations.

### C. *Modes of Limitation of Damages Provided by Section 351(3)*

The first method of limitation enumerated in section 351(3) is "excluding recovery for loss of profits."<sup>51</sup> A request for compensation for loss of profits is most frequently a claim for consequential damages — a separate, cumulative loss that arose because the promised performance was not given. (Consequential damages other than loss of profits can also be excluded by a court, under the phrase "or otherwise."<sup>52</sup>)

A second method of limiting foreseeable damages, specified in section 351(3), is "allowing recovery only for loss incurred in reliance."<sup>53</sup> Reliance loss could include, under *Restatement Second* section 349,<sup>54</sup> either essential reliance loss involved in the performance of the contract, such as a builder's costs for labor and materials, or they could include what earlier writers identified as incidental reliance,<sup>55</sup> loss caused by the

47 Courts have limited damages in such instances by severing the contract or by labeling the breach not material. See *infra* text accompanying notes 189-90.

48 Courts have limited damages in some of these cases by interpreting the conditions as mere promises or as evidentiary requirements. See *infra* text accompanying notes 191-92.

49 See *supra* text accompanying notes 38-46.

50 RESTATEMENT SECOND, *supra* note 3, § 351. Comment f states:

f. *Other limitations on damages.* It is not always in the interest of justice to require the party in breach to pay damages for all of the foreseeable loss that he has caused. There are unusual instances in which it appears from the circumstances either that the parties assumed that one of them would not bear the risk of a particular loss or that, although there was no such assumption, it would be unjust to put the risk on that party. One such circumstance is an extreme disproportion between the loss and the price charged by the party whose liability for that loss is in question. The fact that the price is relatively small suggests that it was not intended to cover the risk of such liability. Another such circumstance is an informality of dealing, including the absence of a detailed written contract, which indicates that there was no careful attempt to allocate all of the risks. The fact that the parties did not attempt to delineate with precision all of the risks justifies a court in attempting to allocate them fairly. The limitations dealt with in this Section are more likely to be imposed in connection with contracts that do not arise in a commercial setting. Typical examples of limitations imposed on damages under this discretionary power involve the denial of recovery for loss of profits and the restriction of damages to loss incurred in reliance on the contract. Sometimes these limits are covertly imposed, by means of an especially demanding requirement of foreseeability or of certainty. The rule stated in this Section recognizes that what is done in such cases is the imposition of a limitation in the interests of justice.

51 RESTATEMENT SECOND, *supra* note 3, § 351(3).

52 *Id.*

53 *Id.*

54 RESTATEMENT SECOND, *supra* note 3, § 349.

55 Fuller & Perdue, *supra* note 7, at 78-80.



breach but not part of the aggrieved party's promised performance. For example, additional overtime salaries for a general contractor's employees, necessitated by the owner's breach, are incidental reliance.

Section 351(3), by use of the phrase "or otherwise,"<sup>56</sup> permits courts to employ additional methods of limiting damages. One constraint placed on a court's action in accordance with this phrase is imposed by the scope of the section itself, which clearly includes consequential damages and probably excludes general damages. An additional constraint is presented by the requirement that, in order to limit damages, a court must decide that "justice so requires in order to avoid disproportionate compensation."<sup>57</sup> For example, in accordance with the dictates of justice, a court could merely reduce the amount of lost profit awarded, rather than exclude it, or similarly reduce other consequential damages.

Whether the scope of section 351(3) is interpreted to include only consequential damages or general damages as well,<sup>58</sup> the phrase "or otherwise" can be utilized by a court that is willing to take the unusual step of dividing a loss between the parties to a contract.<sup>59</sup> One commentator who has studied the few instances of such loss-splitting in other contexts has suggested that section 351(3) can be read to encompass this method of limiting contract damages.<sup>60</sup> The phrase "if . . . justice so requires" would qualify and in appropriate instances support such loss-splitting. Another commentator has noted that a statement in the Comment<sup>61</sup> to section 351(3), authorizing a court to allocate the risk of liability when the parties did not do so, permits a court to engage in loss-splitting.<sup>62</sup> The statement can be interpreted instead, however, to indicate that a court may choose one party to whom to assign the entire risk of liability.

The limiting of foreseeable damages in all of the ways just described is constrained in section 351(3) by the phrase "if . . . in the circumstances justice so requires in order to avoid disproportionate compensation."<sup>63</sup> As is true of other *Restatement Second* sections in which justice is a standard, justice is not a sole criterion but functions in tandem with other requirements. The concept of justice is itself limited by the requirement

56 See RESTATEMENT SECOND, *supra* note 3, § 351(3). The suggestion was offered when the American Law Institute adopted § 351(3) that the section could be invoked to limit reliance damages when both essential and incidental reliance occur, by compensating for either one of these sorts of reliance but not the other. The Reporter stated that he did not recall having observed any instances of such limitation but that it would be permitted by the phrase "or otherwise." 56 ALI PROCEEDINGS 339-40 (1979).

57 RESTATEMENT SECOND, *supra* note 3, § 351.

58 See *supra* text accompanying notes 38-46.

59 American courts virtually always adopt an "either-or" approach: either the defendant bears the loss by paying damages, or the plaintiff bears the loss by being denied damages.

60 Young, *Half Measures*, 81 COLUM. L. REV. 19, 25 (1981). Professor Young writes, however, that such loss-splitting "is not within the spirit of the *Restatement*, as shown by the illustrations, texts, and references that go with the black letter." *Id.* at 30.

61 See *supra* note 50.

62 Stone, *supra* note 8, at 533.

63 RESTATEMENT SECOND, *supra* note 3, § 351.

of disproportion;<sup>64</sup> under section 351(3), the only situations in which justice permits the limiting of damages are those where “disproportionate damages” would otherwise be awarded. The language of section 351(3) thus excludes any other situation in which a court’s sense of justice might call for limiting damages. This could include a court’s wish to reduce damages imposed upon a party who breached accidentally, in good faith; such limitation is not authorized by section 351(3) in the absence of disproportion.

Possible reasons why disproportion has been elevated as the only sort of injustice reached by section 351(3) appear from close examination of the Comment.

Disproportion, usually unfair in itself, can be an indicator of problems in the bargaining process. A great divergence between damage liability and consideration received often results from the parties’ failure to allocate the risk of that particular liability to the party ultimately charged with it. This failure can result from the parties having supposed when they entered the contract that the party who ultimately breached would definitely not bear the risk of that particular liability. It can result also from the parties not having troubled to assign the risk of such liability to either party, primarily in a context of informality of dealing. Failure to allocate the risk of liability for a particular loss to the party in breach is discussed in the Comment to section 351(3).

Although individuals at the moment of entering into a contract generally do not contemplate breach, and although the duty to pay damages is “a secondary duty imposed by law as a consequence of the breach,”<sup>65</sup> there are certain risks so unfair to a promisor, because of disproportion to the consideration received, that he would have refused to enter into the contract had he been aware that the law of damages would impose that risk upon him. In this sense, it can be said that the parties, because they did after all agree to be bound, intended that the promisor not bear that risk.<sup>66</sup> Judicial cognizance that contracting parties do contemplate at least the possibility of breach is evident in the fact that the longstanding requirement of foreseeability of loss is applied to the time of contracting, rather than to the time of breach. A seller of tractor lights, as a reasonable, experienced businessperson, would assume, without consciously advertent to the matter, that his liability for breach did not extend to

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64 The presence of the foreseeability and disproportion requirements that qualify the use of justice in limiting damages rebuts Harvey’s criticism of § 351(3); he described the section as conferring “openended discretion” upon the courts. See Harvey, *supra* note 2, at 675-76. Harvey contrasted § 90 of the RESTATEMENT SECOND as conferring more limited discretion, *id.*; yet that section permits the courts wide latitude in adjusting compensation “as justice requires.” For example, when a grandfather’s unfulfilled promise to give \$2,000 to his granddaughter was relied upon by her, to her detriment, the court, if it had had available § 90 of the RESTATEMENT SECOND, could have awarded either her full expectation of \$2,000, as the court did in *Ricketts v. Scothorn*, 57 Neb. 51, 77 N.W. 365 (1898), or a probably very much smaller sum, the salary she forewent in leaving her job.

65 CALAMARI & PERILLO, *supra* note 8, at 596; see also McCORMICK, *supra* note 8, at 580; 11 S. WILLISTON, CONTRACTS § 1357, at 295 (3d ed. 1968).

66 See, e.g., *Leonard v. New York, Albany & Buffalo Electro-Magnetic Telegraph Co.*, 41 N.Y. 544, 567 (1870) (The court stated that contracting parties are liable for damages which they “would have contemplated as flowing from . . . breach [of the contract], if, at the time they entered into it, they had bestowed proper attention upon the subject . . .”).

responsibility for his purchaser's crop failure even when the seller could foresee that no substitute would be available.<sup>67</sup> A reasonable purchaser would make the same assumption. Had the seller even suspected the remote possibility of such liability, he would have refused to sell the product, insisted upon a contractual term limiting liability, or procured appropriate insurance. As insurance transactions demonstrate, premiums are carefully calculated to compensate an insurance vendor for the burden of bearing the risk of liability for a stipulated loss. Corbin stated that, at the time of the making of the contract, a promisor becomes responsible for any risk of which a reasonable person would then be aware.<sup>68</sup> No reasonable person would believe when entering into a contract that he would be liable for a loss many times the size of the consideration he received; a reasonable person, because he is reasonable, would not make such a contract. As one court stated, "It is not required that the parties *must* have contemplated the actual damages. But the damages must be such, as the parties may fairly be *supposed* to have contemplated, when they made the contract."<sup>69</sup>

In the Official Comment to the Uniform Commercial Code section concerning implied warranty of merchantability, the authors articulated the correlation between paucity of consideration and nonassumption of risk: "In cases of doubt as to what quality is intended, the price at which a merchant closes a contract is an excellent index of the nature and scope of his obligation under the present section."<sup>70</sup> Courts and commentators also have assumed that disproportionately large liability indicates nonallocation of risk.<sup>71</sup> Fuller and Perdue believed that at the time when the parties entered into a contract they agreed that, if necessary, a court would "effectuate its purpose."<sup>72</sup> Under this view, it can be said that the parties contract to incorporate a court's subsequent assessment of damages. They assume when making the contract that the court will act fairly in awarding damages commensurate with the risk of liability undertaken. Chief Judge Cardozo wrote in assessing whether a water company contracting with a city government assumed the risk of indemnifying citizens for enormous fire losses caused by failure to supply the required water: "A promisor will not be deemed to have had in mind the assumption of a risk so overwhelming for any trivial reward."<sup>73</sup>

A possible cause of failure to allocate risk, described by the Comment to section 351(3),<sup>74</sup> is informality of dealing, particularly when no written agreement was prepared. The Comment states further that "the limitations dealt with in this Section are more likely to be imposed in

67 For a discussion of this hypothetical case, see *supra* text accompanying note 21, following *infra* note 77, and accompanying *infra* notes 78, 112.

68 CORBIN, *supra* note 9, § 1010, at 78-79.

69 *Leonard*, 41 N.Y. at 566-67 (Earl, C.J.) (emphasis supplied).

70 U.C.C. § 2-314 comment 7.

71 See, e.g., *Fleming v. Beck*, 48 Pa. 309, 312 (1864); *Cayuga Harvester, Inc. v. Allis-Chalmers Corp.*, 95 A.D.2d 5, 14, 465 N.Y.S.2d 606, 613 (1983).

72 Fuller & Perdue, *supra* note 7, at 58.

73 *H. R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 166, 159 N.E. 896, 898 (1928).

74 See *supra* note 50.

connection with contracts that do not arise in a commercial setting."<sup>75</sup> A noncommercial setting may itself induce less formality and thus less attention to detail in the parties' dealings with one another, and the parties' intention to be legally bound at all may thus be harder to identify. In addition, it is likely that transactions carried on in a noncommercial environment are less frequently intended to be binding. Finally, Fuller and Perdue noted the heightened difficulty of measuring the value of the promised performance in such a setting.<sup>76</sup>

The parties when contracting can reasonably believe that the risk of liability is not allocated to a promisor who receives disproportionately small consideration, regardless of whether the event that later causes loss was foreseeable. Courts and commentators have recognized that foreseeability does not necessarily determine allocation of risk.<sup>77</sup> Both the seller and the purchaser of an irreplaceable tractor light can foresee that failure to deliver the light may cause crop loss if night planting is necessitated by an imminent rainy season, but both would reasonably suppose that the seller of the light is not liable for the entire crop loss. The requirement of foreseeability is by itself insufficient, therefore, to prevent unfairness when damages are charged to a party who did foresee the loss but assumed along with the other party that he would not bear the risk of liability for it.

The charge can be made that a breaching party assumed the risk of liability for a particular loss because any contracting party is held to a knowledge of the relevant contract law. However, as the law itself requires mutual assent to all contract terms, it should not ascribe liability when both parties are unaware of a term imposing that particular liability.

Belief by contracting parties that risk of a particular liability was not allocated to the promisor thus emerges as the chief factor underlying the disproportion standard of section 351(3). Fairness mandates that one who the parties believed did not bear the risk of a particular liability should not be charged with it. To compel that promisor to pay such damages amounts to rewriting his contract to include a term allocating risk to him and could produce substantive unconscionability. A court that limits disproportionate liability because the parties reasonably believed that the risk was not allocated to the breaching promisor is merely enforcing the contract in accordance with the parties' intentions when they entered into the agreement.

When a loss is not charged to a breaching promisor who the parties believed never bore the risk of such liability, the loss unfortunately does not disappear but is necessarily borne by the promisee. How just is this result? Any party who enters a contract undertakes certain risks, princi-

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<sup>75</sup> *Id.*

<sup>76</sup> Fuller & Perdue, *supra* note 7, at 65-66.

<sup>77</sup> See, e.g., *Transatlantic Financing Corp. v. United States*, 363 F.2d 312, 318 (D.C. Cir. 1966) ("Foreseeability or even recognition of a risk does not necessarily prove its allocation."); *FARNSWORTH, supra* note 8, § 9.6, at 687 ("Although the foreseeability of the event will often be a factor that suggests that a promisor assumed the risk of its occurrence, it should not be conclusive on that issue.").

pally that of being unable to perform and thereby breaching. But he also bears the risk of any loss that is caused by the other party's breach unless he has transferred that risk to the other party. Although a farmer can argue that his crop loss was caused by failure to deliver an irreplaceable tractor light, contract law does not impose liability for every consequence of a breach unless the risk of that particular liability has been assigned by the parties. As has been described above,<sup>78</sup> when the \$10,000 value of the crop loss far exceeds the income the seller gained from selling the light, it is highly likely that the parties assumed that the farmer had not transferred that risk. The parties would not normally have expected that by making a \$100 sale the seller became an insurer of the farmer's crop. The reasonable seller would otherwise have charged a much higher price.

Not all disproportion signifies the parties' failure to allocate risk to the breaching party. In some instances, a breaching party may in fact have assumed the risk, as when both parties contract in conscious ignorance of the performance required.<sup>79</sup> The breaching party may simply have been improvident or have succumbed to economic necessity in assuming an inordinately large risk. Here, justice most likely would not require the limiting of damages under section 351(3); the disproportion criterion is only a means of identifying the injustice addressed by that section. Could a converse situation arise in which the parties clearly believed that the breaching promisor did not bear the risk of liability for a particular loss, but the amount of damages for that loss happens not to be mathematically disproportionate to the consideration received? Such a situation is unlikely because the most usual indication that the parties believe that risk has not been allocated to the breaching promisor is disproportion. Absent disproportion, it would be almost impossible to prove the parties' belief that the promisor did not bear the risk, unless it could be shown that the aggrieved party had expressly assumed the risk. The court would of course give effect to such assumption.

A sense that in some instances the parties must have believed that risk of liability for a particular loss had not been allocated to the breaching promisor may underlie even the threshold requirement of foreseeability set forth by section 351(3). Surely a party who had not foreseen the possibility of a particular loss could not have assumed that he bore the risk of such liability. Reluctance to charge parties who reasonably believe that they do not bear risk may thus be a basic policy of the law which both the rule of foreseeability and the section 351(3) rule of disproportion seek to implement.

### III. Comparison of Case and Statutory Law with Section 351(3) and with the Concept of Unconscionability of Remedy

The rules limiting unforeseeable and disproportionate damages can thus be perceived as steps in the development of the concept of fairness

<sup>78</sup> See *supra* text accompanying note 67.

<sup>79</sup> See, e.g., *Leasco v. Taussig*, 473 F.2d 777 (2d Cir. 1972); *Wright and Pierce v. Town of Wilmington*, 290 F.2d 30 (1st Cir. 1961).

in limiting damages — a concept that can also be termed unconscionability of remedy. Willingness of courts to curtail disproportionate contract damages occurs simultaneously with a trend perceived by some commentators toward expansion of contract liability.<sup>80</sup> This is seen in, for example, the prominence of the theory of reliance in the First and Second *Restatement of Contracts*.

As is pointed out in the Comment to section 351(3),<sup>81</sup> tests of foreseeability and certainty have in the past served as disguised methods of combatting disproportion or more general unfairness. Judicial insistence upon mitigation has also fulfilled this function.

*Hadley v. Baxendale*<sup>82</sup> is often viewed as the case in which the requirement of foreseeability of loss originated and is often cited as a clear example of the rule. Yet it has been described by McCormick and other commentators as a case in which lack of foreseeability did not really exist but was invoked in order to prevent the injustice of imposing liability for damages consisting of lost profit upon a carrier who charged only a transportation fee. McCormick,<sup>83</sup> later quoted by Fuller and Perdue,<sup>84</sup> pointed out that the carrier's agent, who promised to transport a broken mill shaft to a company which would use it as a model for manufacturing a replacement, had actually been informed, in McCormick's words, "of the use to which the broken shaft was to be put and that the mill was shut down . . . ."<sup>85</sup> McCormick added that the court nevertheless determined that loss of profit caused by closure of the mill was not foreseeable, because the carrier "was not told that another shaft was not available!"<sup>86</sup> It should be noted that some courts and commentators subsequently concluded that the report of the case must be inaccurate and that the carrier did not know after all that the mill had to be closed.<sup>87</sup> Whether or not loss of profit was foreseeable, the court was probably motivated chiefly by a desire to avoid awarding highly disproportionate damages.<sup>88</sup>

In a much more recently decided case, a court specified lack of foreseeability and lack of certainty as reasons for limiting an award to a party who contracted to sell land to a county government. The plaintiff sought the profit it had anticipated from a domed stadium to be built on the

80 See, e.g., DOBBS, *supra* note 8, at 813. Professor Joseph M. Perillo expressed this view in a conversation September 14, 1987, at the Fordham University School of Law. He pointed to the example of the development of promissory estoppel.

81 See *supra* note 50.

82 156 Eng. Rep. 145 (1854).

83 MCCORMICK, *supra* note 8, at 573.

84 Fuller & Perdue, *supra* note 7, at 86 n.53.

85 MCCORMICK, *supra* note 8, at 573; Fuller & Perdue, *supra* note 7, at 86 n.53.

86 See *supra* note 85.

87 See, e.g., Spang Indus., Inc. v. Aetna Cas. & Sur. Co., 512 F.2d 365, 371 n.8 (2d Cir. 1975) (Mulligan, J.); Victoria Laundry (Windsor) Ltd. v. Newman Indus. Ltd., 2 K.B. 528, 537 (1949); CALAMARI & PERILLO, *supra* note 8, § 14-5, at 593-94 n.34; FARNSWORTH, *supra* note 8, § 12.14, at 874 n.7.

88 See text accompanying *supra* note 8, concerning the view that the requirement of foreseeability is imposed in order to avoid unfairness of remedy. See also DOBBS, *supra* note 8, § 12.3 at 804-05. Professor Dobbs expresses the view that the *Hadley* court may have realized that loss of profit was foreseeable.

land; construction was to have been financed by the county.<sup>89</sup> The intermediate court had refused to grant damages for loss of profit. Two judges of that court pointed out that the underlying but unstated rationale of that court's majority opinion was unwillingness to award "excessive and disproportionate damages."<sup>90</sup> They cited section 351(3) and noted that the informality of the transaction, as well as disproportion, signaled that the risk of this liability had never been allocated to the breaching party.<sup>91</sup> They observed further that if the breaching party had known of such liability, it surely would have demanded more consideration at the time of entering into the contract.<sup>92</sup> This is another way of saying that the parties could not reasonably have expected that the breaching promisor would serve as an insurer for the promisee's eventual loss.

With respect to most cases in which lack of foreseeability, lack of certainty, or failure to mitigate is stated as the reason for limiting damages, one cannot be certain as to the court's underlying goal; yet in many instances courts are probably influenced by reluctance to grant disproportionate damages. For example, in one case, although a court mentioned all three of these reasons for denying consequential damages,<sup>93</sup> there is a strong likelihood that avoiding disproportion was the court's primary rationale. A used jackhammer, probably worth between \$400 and \$450 on the market, was the subject matter of the breached contract. A jury awarded the plaintiff purchaser \$900, which included \$500 for loss of use.<sup>94</sup> The appellate court, in disallowing the \$500 portion of this award, very likely believed that it was disproportionate to the consideration received by the breaching seller. Although the price paid was not stated because the jackhammer was but one of four pieces of merchandise sold as a lot, the court probably believed that the consideration approximated the market value. Damages for loss of use in an amount that exceeded market value, resulting in total damages that were more than twice the market value, can reasonably be said to be disproportionate; it is unlikely that the parties believed at the time of contracting that the seller had been allocated the risk of damages amounting to more than twice what he received.

Another recent opinion in which a court invoked lack of foreseeability as well as lack of certainty as its reasons for denying damages which it probably viewed as disproportionately large concerned sale of steel.<sup>95</sup> The seller of a steel plate needed for construction of a floating barge was held to have breached his contract by supplying steel of such poor quality as to be useless. The court stated that the seller had been aware when contracting of the "general purpose for which plaintiffs required the

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89 *Kenford Co. v. Co. of Erie*, 67 N.Y.2d 257, 262, 493 N.E.2d 234, 236, 502 N.Y.S.2d 131, 133 (1986).

90 *Kenford Co. v. Co. of Erie*, 108 A.D.2d 132, 148-55, 489 N.Y.S.2d 939, 951-56 (1985) (Hancock, J., dissenting), *aff'd.*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986).

91 *Id.*

92 *Id.*

93 *Stanley v. Tinsman*, 159 Me. 17, 18-21, 187 A.2d 401, 403-04 (1963).

94 *Id.* at 20-21, 187 A.2d at 404.

95 *Seaman v. United States Steel Corp.*, 166 N.J. Super. 467, 475, 400 A.2d 90, 94 (1979).

steel, i.e., to fashion the . . . plate . . . ."<sup>96</sup> The court decided, however, that loss of profit was unforeseeable because "plaintiffs did not tell defendants that they contemplated any particular contract or work . . . ."<sup>97</sup> One can argue that it is highly foreseeable to a seller who knows that his purchaser will use the product to build a floating crane, that the owner of such a device will employ it for business rather than as a pleasure craft. The court refused also to award rental value, on the ground of uncertainty.<sup>98</sup> The rental value, found by the jury to be \$85,000, had been awarded by the trial court. The defendant seller had been paid only \$410.45 for the plate. The appellate court noted that had the defendant foreseen the plaintiff's loss of profit, it might have insisted upon a contract term limiting its liability.<sup>99</sup> This statement indicates that disproportion of liability to consideration was probably the court's true reason for denying damages for rental value.

The cases just described illustrate covert judicial attack on disproportion. A legislative provision that lends itself to covert avoidance of disproportionate damages is the Uniform Commercial Code requirement of foreseeability of a buyer's consequential damages.<sup>100</sup> In addition, the Code sections concerning course of dealing,<sup>101</sup> usage of trade,<sup>102</sup> and course of performance<sup>103</sup> provide courts with flexibility in interpreting contracts so as to hold that the parties have impliedly agreed to terms that may affect measurement of damages or may affect the determination of whether in fact any breach occurred.

A few courts have overtly declared that disproportion precludes awarding consequential damages. The dissenting opinion in the case described above, concerning construction of a domed stadium,<sup>104</sup> is an example of such candid statements.

In 1892, a court openly declared that its reason for limiting an award of damages was the potentially large size of the total.<sup>105</sup> The court implied that such an unfairly large sum of money justified a holding of lack of foreseeability.<sup>106</sup> In an even earlier case, the facts of which are reminiscent of *Hadley v. Baxendale*,<sup>107</sup> a mill owner claimed damages for loss of profit caused by the stopping of the mill when a millwright breached a contract whereby he had agreed to dress four millstones for a total reimbursement of \$232.<sup>108</sup> The court refused to award the requested sum,

96 *Id.* at 472, 400 A.2d at 93.

97 *Id.*

98 *Id.* at 475, 400 A.2d at 94.

99 *Id.* at 472, 400 A.2d at 93. The court probably meant that what was unforeseeable was the defendant's liability for the loss, rather than the loss itself.

100 U.C.C. § 2-715(2)(a).

101 *Id.* at § 1-205.

102 *Id.*

103 *Id.* at § 2-208.

104 *Kenford Co.*, 108 A.D.2d at 148-55, 489 N.Y.S.2d at 951-56 (1985) (Hancock, J., dissenting), *aff'd.*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 13 (1986).

105 *Rochester Lantern Co. v. Stiles & Parker Press Co.*, 135 N.Y. 209, 218, 31 N.E. 1018, 1021 (1892).

106 *Id.* at 218, 31 N.E. at 1021.

107 156 Eng. Rep. 145 (1854).

108 *Fleming v. Beck*, 48 Pa. 309, 312 (1864).



pointing out that the recipient of such a relatively small amount of consideration would not have known that he assumed the risk of liability for foreseeable loss of profit when the mill was closed due to his breach.<sup>109</sup> Whenever a court holds that a party who received disproportionately small consideration would not reasonably have known that he bore the risk of a particular loss, it is logical to assume that the court believed also that the other party shared that lack of knowledge.

When a plaintiff farmer claimed \$10 million in damages for failure of his corn crop due to breach of warranty by the manufacturer of a harvesting machine sold to him for \$142,213, the court alluded to the failure to allocate risk indicated by the disproportion between the damages sought and the consideration received by the breaching party.<sup>110</sup> The court declared, "It defies reason to suppose that defendant [manufacturer] could have intended to assume such risks."<sup>111</sup> This decision is the basis for the second of the three illustrations in the Comment to section 351(3), concerning a tractor light. This same illustration is discussed earlier in this article.<sup>112</sup>

A number of courts have enforced contract clauses that limit damage liability; in these instances, the courts have openly named disproportion between potential liability and consideration received by the breaching party as the ground of decision. Cases involving agreements to install and monitor burglar alarm systems exemplify this sort of situation.<sup>113</sup> These courts may have drawn support from the policy of respecting freedom of the parties to select their own contractual terms, but the stated, and probably principal, ground of decision is disproportion. Such cases are distinguishable from actions involving liquidated damage clauses, to which different criteria are applied.<sup>114</sup>

Section 351(3) itself is, of course, an overt statement of the rule of disproportion. The Comment to section 351(3)<sup>115</sup> points out that some courts have indicated covertly their disapproval of disproportionate damages by using particularly stringent tests of foreseeability and of certainty. This statement implies that candor is a primary objective of the section. The overt use of disproportion as an intended means of avoiding unfairness is indicated by the closing phrase of the Comment, which declares that the limitation on damages is imposed "in the interests of justice."<sup>116</sup>

109 *Id.* at 312.

110 *Cayuga Harvester, Inc. v. Allis-Chalmers Corp.*, 95 A.D.2d 5, 14-15, 465 N.Y.S.2d 606, 613 (1983).

111 *Id.* at 14, 465 N.Y.S.2d at 613.

112 *See* Reporter's Note to Comment f to § 351. *See supra* text accompanying notes 21, 67-69, 78 and following note 77.

113 *See, e.g.*, *Central Alarm of Tucson v. Ganem*, 116 Ariz. 74, 78, 567 P.2d 1203, 1207 (1977); *Rinaldi & Sons, Inc. v. Wells Fargo Alarm Service, Inc.*, 47 A.D.2d 462, 466, 367 N.Y.S.2d 518, 522 (1975), *rev'd on other grounds*, 39 N.Y.2d 191, 347 N.E.2d 618, 383 N.Y.S.2d 256 (1976); *Vallance & Co. v. De Anda*, 595 S.W.2d 587, 590 (Tex. Civ. App. 1980).

114 *See infra* text accompanying notes 198-99.

115 *See supra* note 50.

116 *Id.*

Whether or not the scope of section 351(3) encompasses general damages,<sup>117</sup> courts have for some time been limiting disproportionate general damages, often employing various rules, to be described below,<sup>118</sup> that are apparently modes of approaching the goal of fairness and thereby avoiding unconscionability of remedy. On rare occasions, courts have overtly stated that general damages are disallowed because of disproportion to consideration.<sup>119</sup> Even if general damages are not covered by section 351(3), courts can nevertheless continue to limit them, as part of the ongoing attempt to approach the goal of fairness.

Among the rules applied to curtail general as well as consequential damages perceived to be unfairly large is commercial impracticability, articulated in both the Uniform Commercial Code<sup>120</sup> and the *Restatement Second*.<sup>121</sup> The result is often more drastic than a mere limitation of remedy, since the party who proves impracticability is exonerated from paying any damages at all with respect to the portion of the goods involved. (The Official Comment to the Code provision suggests, however, that rather than hold that no damages are payable, a court may make an "adjustment" when "neither sense nor justice" would otherwise be achieved.<sup>122</sup>)

The Uniform Commercial Code requires that if a party is to be excused on the ground of impracticability from paying damages, an event unforeseen by either party must cause the extreme difficulty of performance.<sup>123</sup> This requirement might appear at first to distinguish cases in which courts limit damages as disproportionate. Yet the most likely cause of disproportion of general damages is an unexpected and drastic change in the market price subsequent to contracting, such that the breaching seller must pay a cover price the excess of which over the contract price is many times greater than the consideration agreed upon. The most likely cause of such a drastic change in market price is a shortage of the goods concerned. The Official Comment<sup>124</sup> to the Uniform Commercial Code provision concerning commercial impracticability states that although "a rise or collapse in the market" is not "in itself a justification" for excusing a party from paying damages, "a severe shortage of raw materials or of supplies due to a contingency such as . . . local crop failure, unforeseen shutdown of major sources of supply or the

117 See *supra* text accompanying notes 38-46.

118 See *infra* text accompanying notes 120-47.

119 See *infra* text accompanying notes 137-41.

120 U.C.C. § 2-615(a). Section 2-615 provides in part:

Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:

(a) Delay in delivery or non-delivery in whole or in part by a seller who complies with paragraphs (b) and (c) is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

121 RESTATEMENT SECOND, *supra* note 3, § 261.

122 U.C.C. § 2-615 comment 6.

123 U.C.C. § 2-615(a). See *supra* note 120.

124 U.C.C. § 2-615 comment 4.

like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance" qualifies as the required unforeseen event.<sup>125</sup>

Most cases of extreme disparity between the contract price and the market price at the time performance is due would be caused by the sort of unforeseen, severe shortage described in the Official Comment just quoted. Exceptions exist; for example, a purchaser of advertising in the Yellow Pages might prove that breach by the seller has caused him disproportionately large damages because no similar advertising medium exists and the cost of substitute performance is therefore many times the contract price.<sup>126</sup> Unless other facts were introduced to show an unforeseen contingency, the breaching party here could not claim the benefit of any unexpected severe shortage. One reason why this fact situation is atypical is the unusual circumstance that competing sellers do not exist, so that there is actually no general market for the particular service. Advertising through other media such as radio or television or newspapers could be described as relating to an entirely different market, with appropriately differing prices. With the exception of unusual fact configurations such as that just described, most cases of disproportion between general, market-based damages and contract price meet the criteria established by the Official Comment for limiting or excusing damages due to commercial impracticability.

Courts have nevertheless been hesitant to limit damages by applying section 2-615,<sup>127</sup> and particularly so when the central reason for claiming impracticability under the Code is drastically increased cost of performance. In commenting on litigation involving very large damage claims attributable to a seller's inability to procure promised uranium when the market price was alleged to be three and, possibly, four times the contract price,<sup>128</sup> a federal judge indicated that commercial impracticability would not excuse the seller. He referred, however, to "a serious issue of limitation of liability" and to "the equitable considerations which weigh in favor of compromise."<sup>129</sup>

Courts can be said to limit disproportionate general damages, in order to avoid great unfairness, by selecting among alternative methods of measuring such damages. For example, when a construction contract is

<sup>125</sup> *Id.*

<sup>126</sup> In *Triebwasser & Katz v. American Telephone & Telegraph Co.*, 535 F.2d 1356 (2d Cir. 1976) (Mulligan, J.), the plaintiff, who sought (and was denied) a preliminary injunction to compel the publisher of the Yellow Pages to print its advertisement, alleged that the cost of substitute advertising in other media would be \$2,400,000 per year.

<sup>127</sup> See, e.g., *Neal-Cooper Grain Co. v. Texas Gulf Sulphur Co.*, 508 F.2d 283, 283-84 (7th Cir. 1974) ("The cost increase necessary . . . must be more than merely onerous or more expensive. It must be positively unjust . . ."); *Transatlantic Fin. Corp. v. United States*, 363 F.2d 312 (D.C. Cir. 1966). A rare pre-Code case in which the court excused a promisor from paying damages when the cost of performance, "10 or 12 times" the usual cost, was "prohibitive" and therefore had "the effect . . . of making performance impracticable" is *Mineral Park Land Co. v. Howard*, 172 Cal. 289, 291, 293, 156 P. 458, 459, 460 (1916). See also FARNSWORTH, *supra* note 8, § 96, at 680; Jennings, *Commercial Impracticability — Does It Really Exist?*, 2 WHITTIER L. REV. 241, 256 (1980).

<sup>128</sup> Westinghouse Annual Report, quoted by E. FARNSWORTH & W. YOUNG, *CASES AND MATERIALS ON CONTRACTS* 981 n.b (3d ed. 1980).

<sup>129</sup> Judge Merhige (E.D. Va.) in an excerpt from the Record, quoted in FARNSWORTH & YOUNG, *supra* note 128, at 981 n.b.

breached by a builder who has nevertheless rendered substantial performance, the aggrieved party is given either the cost of completing the performance promised him or the diminution in value of his property. Either approach can be described as fully compensating his expectation; yet, if damages are confined to diminution in value, the court may after all be limiting his general damages. Even though the award when added to the present value of the property will equal the full expected value after performance, the aggrieved party was promised a particular performance, not an increase in the value of his land. To say that land value is one yardstick for measuring his expectation does not insure that it is the fairest such yardstick. Without abandoning substitutional relief to grant specific performance, a court could conclude that only the monetary value of the promised performance will fully compensate the aggrieved party, regardless of whether such value greatly exceeds the decrease in property value. To give less compensation to the plaintiff is to limit his damages. This mode of limiting general damages has been frequently utilized.<sup>130</sup> For example, a husband and wife who contracted to permit strip-mining of their farm on condition that the topography of the area be restored to its former state after mining were awarded, when the restoration was not done, only the reduced value of their land, \$300, rather than the cost of returning it to the promised state, \$29,000.<sup>131</sup> Because the land was worth relatively little when the contract was made, the court said that even were the restorative work done, the total value of the property would be less than the cost of restoration.<sup>132</sup> The court noted that damages measured by cost of performance of the contract would be "within the meaning of" a state statute that proscribed the awarding of "unconscionable and grossly oppressive damages, contrary to substantial justice."<sup>133</sup> Perhaps it could have been argued on behalf of the plaintiff farm owners that the contract price agreed to in exchange for undoubtedly valuable minerals may have been much lower than otherwise, to allow for the high cost of restoration. The plaintiffs' true loss would therefore encompass the money saved by the purchaser in failing

130 See, e.g., *Hansen v. Andersen*, 246 Iowa 1310, 71 N.W.2d 921 (1955); *Jacob & Youngs v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921) (Cordozo, C.J.).

131 *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109 (Okla.), cert. denied, 375 U.S. 906 (1963). Twenty years after the *Peevyhouse* decision, the United States Court of Appeals for the Tenth Circuit, applying Oklahoma law to a similar fact pattern involving failure to restore strip-mined land, measured damages by cost of completing performance. The principal ground for the decision was the enactment subsequent to *Peevyhouse* of an Oklahoma statute imposing a duty upon operators of strip mines to reclaim the mined land. *Rock Island Improvement Co. v. Helmerich & Payne, Inc.*, 698 F.2d 1075, 1078 (10th Cir.), cert. denied, 461 U.S. 944 (1983).

132 *Peevyhouse*, 382 P.2d at 111. See Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1392-93, in which Prof. Yorio points out that although awarding the cost of completing performance may over compensate a landowner who might pocket the money, awarding mere diminution in value may undercompensate him. Prof. Yorio states that under such circumstances the landowner "should be favored over the [other party] because the [landowner] is completely innocent and the [other party] deliberately reneged on [its] promise." *Id.* at 1393. Prof. Farnsworth has suggested, "Where the loss in value to the owner is uncertain, and cost to complete and diminution in market price differ widely, it would be better to give the trier of fact discretion to fix any figure, not unreasonable under the circumstances, as long as it lies within those two limits." Farnsworth, *supra* note 9, at 1175.

133 *Peevyhouse*, 382 P.2d at 113.

to restore the land because that would otherwise have been part of the contract price. Restitution would then be an appropriate remedy.<sup>134</sup>

Additional alternative methods of measuring damage exist which can limit or expand the resultant award. One such technique is assessment of the rental value of machinery to determine the worth of lost use of it when a contract to transport the machinery was breached.<sup>135</sup> Breach of a contract to transport perishable goods may result in a grant of the diminution in value of the goods.<sup>136</sup>

A case in which the court frankly labeled general damages "quite disproportionate" in comparison with consideration received by the breaching party<sup>137</sup> is the source of the third of three illustrations in the Comment to section 351(3). The court ruled that a plastic surgeon had, contrary to usual medical practice, made a contract<sup>138</sup> with his patient in which he promised to improve the appearance of her nose and had breached it by producing a nose that was in fact less pleasing in appearance than before surgery. The court pointed out that expectation damages would consist of the difference in value between the promised nose and the nose in its present state. These would be general damages because they would be based upon the value of the promised performance rather than on a separate, resulting loss such as, for example, loss of employment due to change in appearance. (The plaintiff was an entertainer.) The court refused to grant expectation damages and gave instead: (1) reliance damages to compensate the patient "for the worsening of her condition," for pain and suffering caused by a third operation beyond the two operations expected, and out-of-pocket expenses and (2) restitution for the doctor's fee.<sup>139</sup> The court stated that for physicians' breach of contract in doctor-patient cases "an expectancy measure might be thought harsh" because "the fee paid by the patient to the doctor for the alleged promise would usually be quite disproportionate to the putative expectancy recovery."<sup>140</sup> The court also noted the difficulty of valuing the promised appearance of the patient's nose and the lessened need to grant expectation damages in a noncommercial setting; it termed the context a "special situation."<sup>141</sup>

Disproportionately large general damages with respect to volatile, rapidly fluctuating markets have been limited by courts in a significant minority of contract cases.<sup>142</sup> For example, in one case involving charter of a vessel, the contract price was lower than the market price at the time

134 See Perillo, *Restitution in a Contractual Context*, 73 COLUM. L. REV. 1208, 1214 (1973), in which Prof. Perillo demonstrates that restitution, although a contractual remedy, is often not acknowledged as such.

135 See, e.g., *Hector Martinez & Co. v. Southern Pacific Trans. Co.*, 606 F.2d 106, 110 (5th Cir. 1979), *cert. denied*, 446 U.S. 982 (1980); *Resolute Ins. Co. v. Percy Jones, Inc.*, 198 F.2d 309, 312 (10th Cir. 1952).

136 See, e.g., *Gulf, Colorado & Sante Fe Ry. Co. v. Texas Packing Co.*, 244 U.S. 31, 37 (1917).

137 *Sullivan v. O'Connor*, 363 Mass. 579, 585-86, 296 N.E.2d 183, 187-88 (1973). See Reporter's Note to comment f to § 351.

138 *Id.* at 583, 296 N.E.2d at 186.

139 *Id.* at 588, 296 N.E.2d at 189.

140 *Id.* at 586, 296 N.E.2d at 188.

141 *Id.*

142 See *Simon & Novack*, *supra* note 9, at 1397.

of breach but much higher than the market price subsequent to breach. The difference occurred because the market fell when the Yom Kippur War began. The court awarded approximately \$6.6 million rather than the \$30 to \$40 million cost of cover on the market at the time of the breach.<sup>143</sup> The plaintiff, who did not arrange for substitute performance, was limited to its loss from a subcharter contract it had entered and breached and to receipt of payment under a settlement agreement it had made with the defendant. The court considered, among other factors, the plaintiff's failure to procure substitute performance and its intention to invest any damages received rather than apply them to future charter of a vessel.<sup>144</sup>

In another recently decided case in which a seller breached by making late delivery of promised shares of restricted stock, the court refused to grant disproportionately large general damages based upon the difference between the contract price and the higher market price at the time delivery was due.<sup>145</sup> The reason given by the court was that the plaintiff did not prove that he would have resold the shares at that time, instead of holding them for investment.<sup>146</sup>

General, market-based damages have been refused to aggrieved purchasers of real property when impairment of the seller's title caused breach of contract. Such purchasers have received only return of money paid and compensation of other expenses incurred.<sup>147</sup>

The foregoing discussion indicates that a few courts have overtly declared that disproportion will prevent imposition of unjustly large damages, both consequential damages and general damages.<sup>148</sup> To this extent, judicial effort mirrors the achievement of section 351(3). As has also been shown, other courts as well as legislative bodies have covertly refused to award disproportionate damages, through use of other rules such as foreseeability<sup>149</sup> and commercial impracticability.<sup>150</sup> All these decisions, both those that candidly mention disproportion and those that do not, can be seen as pursuing the prevention of unconscionability of remedy.

An examination of possible alternatives and supplements to section 351(3) will reveal many strengths and a few potential weaknesses of the section.

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143 *Compania Naviera Asiatic v. The Burmah Oil Co.*, No. 74-2025 (S.D.N.Y. Apr. 27, 1977) (Frankel, J.), is cited in Simon & Novak, *supra* note 9, at 1427 n.126. The 70 page decision is unreported; Simon and Novak were counsel for the plaintiff.

144 *Id.*

145 *Kaufman v. Diversified Industries, Inc.*, 460 F.2d 1331 (2d Cir. 1972) (Kaufman, J.)

146 *Id.* at 1337.

147 *See, DOBBS, supra* note 8, § 12.8, at 834; McCORMICK, *supra* note 8, at 686-87.

148 *See supra* text accompanying notes 104-14, 137-41.

149 *See supra* text accompanying notes 81-103.

150 *See supra* text accompanying notes 120-29 concerning use of impracticability and accompanying notes 130-37 concerning use of other rules.

#### IV. Evaluation of Section 351(3) and of Possible Alternatives and Supplements

Among the principal achievements of section 351(3) are the candor and clarity with which it states the policy of avoiding injustice based on disproportion, which courts and legislatures have pursued in a long-term trend toward prevention of unconscionability of remedy. Any alternative or supplement should accomplish at least that much. Another significant achievement is enhancement of predictability. Individuals will be encouraged to enter contracts when shielded from the danger of unexpectedly being held to have insured the other party's interests in exchange for a disproportionately small recompense. Further valuable characteristics of section 351(3) become apparent upon examining the forceful criticisms leveled at use of lack of foreseeability as a sole criterion for limiting damages.<sup>151</sup>

The foreseeability requirement has been criticized as providing an "all-or-nothing" remedy.<sup>152</sup> Section 351(3), in contrast, affords flexibility in limiting damages and may even, as commentators have suggested, permit apportionment of losses between contending parties.<sup>153</sup>

The "fictitious" nature of the foreseeability rule has been recognized.<sup>154</sup> Fuller and Perdue wrote that "[t]he simplicity and comprehensiveness of this test are largely a matter of illusion."<sup>155</sup> They pointed out that foreseeability is not "a single test" but is in actuality "a whole set of tests," the application of which determines merely "[t]hose items of damage for which the court feels [the defendant] ought to pay."<sup>156</sup> Another commentator described the "manipulability" of the foreseeability rule.<sup>157</sup> The test of disproportion as indicative of failure to allocate risk to the breaching party is instead direct, clear, precise.<sup>158</sup> It mandates inquiry into the intent of reasonable persons at the time of contracting while providing a visible standard that will not permit obfuscation; extreme disproportion is not easily overlooked or mistaken. The rule of disproportion functions within section 351(3) as a backup for foreseeability, by insuring against a finding of liability for loss which is adjudged foreseeable but which is nevertheless unjust because its risk was never allocated to the breaching promisor. The foreseeability requirement has been criticized for "its common inadequacy as a shield from claims that are easy to view as excessive."<sup>159</sup> A primary purpose of section 351(3) is prevention of awards of unfairly excessive damages. The foreseeability rule has been described as "a prime candidate for replacement, refine-

151 It has been suggested, in fact, that the foreseeability requirement "ought to be subject to review, lest we make too big an investment in it even as it is becoming outmoded." Danzig, *supra* note 9, at 284.

152 Comment, *supra* note 8, at 1020, 1023.

153 See *supra* text accompanying notes 59-62.

154 See *supra* text accompanying note 6.

155 Fuller & Perdue, *supra* note 7, at 85.

156 *Id.*

157 See Harvey, *supra* note 2, at 674.

158 Yet, § 351(3) itself has been criticized as imprecise. See Harvey, *supra* note 2, at 677-79.

159 See Harvey, *supra* note 2, at 674.

ment, extension or supplementation.”<sup>160</sup> Section 351(3) supplements and refines the foreseeability rule in a manner that effectuates what must have been the primary intention of the American Law Institute: prevention of extreme unfairness. Indeed, one commentator has said of the foreseeability requirement: “[I]t often happens that the expression of a principle turns out, as judicial experience accumulates, to be an inaccurate or unsatisfactory formulation of the fundamentally sound idea. This may prove to be the case with *Hadley’s* formulation of the limits of contract recovery.”<sup>161</sup>

Fair evaluation of section 351(3) necessitates an assessment of alternatives that may accomplish more fully the same goals or may achieve more desirable ends.

An alternative which has been utilized by a few courts fails to provide the candor, clarity, and predictability of section 351(3), although it bears a superficial resemblance to this section and to the concept of unconscionability of remedy. It is the tacit agreement test. Justice Holmes, writing for the United States Supreme Court, refused to award foreseeable damages to a breaching party who had not agreed, at least impliedly, to assume the risk of liability at the time he entered the contract.<sup>162</sup> A small number of states have continued to impose this limitation upon the granting of damages.<sup>163</sup> The Comments to the Uniform Commercial Code<sup>164</sup> and to the *Restatement Second*<sup>165</sup> have expressly rejected the tacit agreement test. It is a limitation much more extensive than section 351(3). Under section 351(3) a breaching promisor must pay damages unless the parties assumed that he would not bear the risk of liability or unless, because of informality in dealing, they did not allocate the risk to him. Under the tacit agreement test, in contrast, a breaching promisor must pay damages only if he agreed, impliedly or expressly, to assume such liability — which can be difficult to prove. Under section 351(3), the norm is to award damages unless the breaching party is exonerated therefrom by disproportion, whereas under the tacit agreement test, the norm is not to award damages absent proof of the breaching party’s assent to pay. As Williston observed, parties to a contract infrequently contemplate damages, or even breach, when entering into the transaction.<sup>166</sup> The parties may nevertheless assume that a certain risk has been allocated to one of them, but it is unlikely that the one to whom it has been allocated will indicate even tacitly his assent to be held liable. Justice Holmes, in imposing the tacit agreement test, wrote that a breaching promisor’s liability “should be worked out on terms which it fairly may be presumed he would have assented to if they had been presented to his

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160 *Id.*

161 DOBBS, *supra* note 8, § 12.3, at 804.

162 *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540 (1903). One of the earliest English cases in which this rule was applied is *British Columbia Saw-Mill Co. v. Nettleship, L.R.*, 3 C.P. 499, 500 (1868).

163 *See, e.g., Hawkins v. Delta Spindle of Blytheville*, 245 Ark. 830, 434 S.W.2d 825 (1968); *Keystone Diesel Engine Co. v. Irwin*, 411 Pa. 222, 191 A.2d 376 (1963).

164 U.C.C. § 2-715 comment 2.

165 RESTATEMENT SECOND, *supra* note 3, § 351 comment a.

166 11 WILLISTON, *supra* note 65, § 1357, at 295.



mind."<sup>167</sup> Holmes insisted that the breaching promisor "must know that the person he contracts with reasonably believes that he accepts the contract with the special condition attached to it."<sup>168</sup> In contrast, it is interesting to discover that some courts which purported to impose the tacit agreement test and cited earlier cases applying that test actually employed disproportion and resultant belief in nonallocation of risk as the grounds for limiting damages.<sup>169</sup> These courts, believing that they were applying the tacit agreement test, moved instead to the requirement of disproportion. Their opinions are therefore precursors of section 351(3). In other cases, both disproportion and failure to satisfy the tacit agreement test served as the bases for decision.<sup>170</sup>

Professor Farnsworth, draftsman of section 351(3), suggested in an article predating the *Restatement Second* that whereas the tacit agreement test required a fictional assent to bear risk,<sup>171</sup> a "showing that . . . the risk was *not* assumed by the promisor" would be an overt criterion.<sup>172</sup> Section 351(3), which utilizes disproportion of consideration to signal the parties' belief that the promisor did not assume the risk, does employ a candid and more lucid criterion. These attributes enhance predictability.

The tacit agreement test does not encourage, as does section 351(3), the open acknowledgement of unfairness. There is much room for judicial manipulation of what actions constitute tacit agreement; unpredictability can be increased thereby. Although no mathematical standard of disproportion exists, the requirement of extreme disproportion between amount of damage and amount of consideration contributes to predictability. With respect to both substantive and procedural unconscionability, courts have identified and refused to condone extreme unfairness without having created problems of lack of predictability.<sup>173</sup> Courts should also be able to perceive extreme unfairness of remedy, whether labeled disproportion or unconscionability of remedy. Parties will be encouraged to enter more readily into contractual transactions by judicial enunciation of disproportion or unconscionability of remedy; they will be relieved of the threat of being held as insurers of tremendous loss in return for insignificant consideration. The tacit agreement test, on the other hand, can create fear of entering into contracts when courts are reluctant to award even fair measures of damages unless a difficult test of tacit agreement has been met. On the occasion of the approval of section 351(3) by the American Law Institute membership, the tacit agreement test was suggested by a motion from the floor as a substitute for the dis-

<sup>167</sup> *Globe Refining*, 190 U.S. at 540.

<sup>168</sup> *Id.* at 545.

<sup>169</sup> See, e.g., *Hooks Smelting Co. v. Planters' Compress Co.*, 72 Ark. 275, 285-87, 79 S.W. 1052, 1056-57 (1904); *Snell v. Cottingham*, 72 Ill. 161, 170 (1872) ("Had it been known it was expected appellees would be held responsible for such extraordinary damages, it is hardly probable that they would have entered into the contract . . .").

<sup>170</sup> *Flug v. Craft Mfg. Co.*, 3 Ill. App. 2d 56, 63, 66-67, 120 N.E.2d 666, 669, 671 (1954); *Lamkins v. Int'l Harvester Co.*, 182 S.W.2d 203, 205-06 (1954). (*Lamkins* is cited in the Reporter's Note as the basis for illustration 18 to § 351(3). Its use as such does not imply, however, that § 351(3) employs the tacit agreement test. The contrary is expressly stated in comment *a* to § 351.)

<sup>171</sup> Farnsworth, *supra* note 9, at 1208-09.

<sup>172</sup> *Id.* at 1210.

<sup>173</sup> See cases cited *supra* notes 11-12.

proportion requirement of section 351(3). This motion was subsequently withdrawn by its maker.<sup>174</sup>

A second alternative to section 351(3) would permit courts to limit foreseeable damages by determining explicitly that the parties believed that risk of a particular liability had not been allocated to the promisor, without use of the tests of justice or, at least, of disproportion.<sup>175</sup> This technique addresses the concern expressed in the Comment to section 351(3),<sup>176</sup> regarding the parties' failure to allocate risk of liability. The major criticism of this criterion is that it would not offer the precision of the test of disproportion. Predictability and willingness to enter into contracts would thereby be decreased.

A third alternative that would be less effective than section 351(3) would retain disproportion as the exclusive indicator of injustice because of its precision and its usefulness in identifying the parties' failure to allocate risk, but would eliminate altogether the threshold requirement of foreseeability. This proposal may at first appear useful because of the problems associated with the foreseeability concept: foreseeability is a standard much less precise than proportion; it has led courts to state their reasoning much less overtly than does section 351(3); and it does not assure that a promisor has been allocated a risk of liability. Nevertheless, foreseeability performs a necessary function in section 351(3). Elimination of the requirement and retention of only the disproportion limitation could mandate awarding of damages caused by unforeseeable circumstances when such damages are nevertheless in numerical proportion to consideration received by the breaching party. On the other hand, a court applying an openly articulated prohibition against unconscionability of remedy could abandon the threshold requirement of foreseeability, because prohibiting an unconscionable remedy would preclude liability for unforeseeable, though proportionate, harm.

Danzig has suggested that the rule of foreseeability established in *Hadley v. Baxendale*,<sup>177</sup> usually interpreted as addressing foreseeability of type but not of size of liability, does not prevent unfairness when a party foresaw the type of harm but not the magnitude of the loss.<sup>178</sup> Section 351(3) would avoid injustice in such a situation, but only if the loss were disproportionately large in comparison with consideration received by the breaching party. It would not reach a situation in which loss of a foreseeable type is proportionate to consideration but nevertheless is much larger in size than was foreseen. This problem would be averted if subsection one of section 351, which contains the threshold foreseeabil-

174 56 ALI PROCEEDINGS 340-43 (1979).

175 Failure to allocate risk as a criterion for limiting damages was suggested in Farnsworth, *supra* note 9, at 1210. See *supra* text accompanying notes 171-72 for a discussion of Prof. Farnsworth's observation that use of this standard would solve problems created by the fictitious nature of the tacit agreement test. The possibility of replacing the justice-based disproportion requirement with language concerning factors that would "seem to indicate that [the parties] did not intend to allocate risks in the normal foreseeable fashion" was suggested by Dean John E. Murray, Jr., at the time of the adoption of § 351(3). 56 ALI PROCEEDINGS 345 (1979).

176 See *supra* note 50.

177 156 Eng. Rep. 145 (1854).

178 Danzig, *supra* note 9, at 283. See also *supra* note 43.

ity requirement, were amended by insertion of the phrase "in type or size" so that it would state: "(1) Damages are not recoverable for loss that the party in breach did not have reason to foresee, in type or size, as a probable result of the breach when the contract was made." This difficulty would be resolved also by invoking the concept of unconscionability of remedy to justify limiting of damages.

Although contractual remedies are imposed to compensate the aggrieved party rather than to punish the breaching party, some courts may choose to apply the section 351(3) limitation only when the breach was not wilful or even only when it was not negligent; these courts may hold that only under such circumstances is limitation required by justice, which is the criterion stated in section 351(3). McCormick believed that wilfulness was taken into account by courts, along with disproportion of damages to consideration, in deciding whether loss was foreseeable.<sup>179</sup> Other commentators have predicted that courts may make increasingly frequent reference to fault in rendering damage awards for breach.<sup>180</sup> Professor Farnsworth wrote, before the drafting of the *Restatement Second*, that wilfulness may be useful in rebutting a claim that the breaching party had not assumed the risk of liability for a particular loss.<sup>181</sup> In a rare judicial statement that disproportion was a ground for limiting general damages, a court observed that another jurisdiction might refuse to impose such a limitation when wilfulness was present.<sup>182</sup> Lack of wilfulness is frequently a criterion in awarding the contract price (less damages), under the doctrine of substantial performance, to a breaching plaintiff<sup>183</sup> and is also weighed in granting him restitution.<sup>184</sup> Even a wilfully breaching party should be treated fairly, however, and therefore it can be argued that the extreme divergence between liability and consideration that section 351(3) recognizes as disproportion would characterize a remedy unfair even when breach was wilful.

Finally, courts could recognize the concept of unconscionability of remedy as an alternative or supplement to section 351(3). Both disproportion and unconscionability as grounds for limiting foreseeable damages would eliminate unfairness, and both would be applicable principally in situations in which the parties had not allocated to the breaching promisor the risk of a particular liability. Both, therefore, would prevent a party who sold a \$100 tractor light from being held insurer of a farmer's \$10,000 crop. A subtle difference in application could exist. It is possible that disproportion would be invoked more frequently depending upon how a court interprets the terms "justice" and "disproportion." Whereas the term "unconscionability," as applied to date by courts, has meant unfairness so extreme as to offend the conscience of

179 MCCORMICK, *supra* note 8, at 571.

180 *E.g.*, Simon & Novack, *supra* note 9, at 1426-27.

181 Farnsworth, *supra* note 9, at 1209.

182 Sullivan v. O'Connor, 363 Mass. 579, 588 n.6, 296 N.E.2d 183, 189 n.6 (1973). See *supra* text accompanying notes 137-41 for a discussion of this case.

183 See, *e.g.*, Samuel J. Creswell Iron Works, Inc. v. Hous. Auth. of Camden, 449 F.2d 557, 561 (3d Cir. 1971); Glazer v. Schwartz, 276 Mass. 54, 56-57, 176 N.E. 613, 614-15 (1931).

184 See, *e.g.*, Harris v. The Cecil N. Bean, 197 F.2d 919, 922 (2d Cir. 1952); Glazer v. Schwartz, 276 Mass. 54, 57, 176 N.E. 613, 614-15 (1931).

the court,<sup>185</sup> and in fact the root of the word suggests such a high standard, courts could conceivably find that injustice is indicated by disproportion involving great but not extreme disparity. The Comment<sup>186</sup> to section 351(3) speaks of "extreme disproportion," however, and courts would be likely to guide their interpretations by this indication of the intention of the American Law Institute. In testing for unconscionability of remedy, a court may be tempted to ask whether, had the parties expressly agreed to this particular liability in their contract, the term would be adjudged so unfair as to be unconscionable. Yet this test may not be a fair method of measuring unconscionability of remedy. A term may not appear to a court to be as unfair when a party willingly assented to it at the time of contracting as when it is imposed upon a party who did not know when contracting that he bore the risk of such liability.

It is more likely that courts would interpret "unconscionability of remedy" to apply more broadly than section 351(3), to embrace circumstances in which unfairness other than disproportionate consideration exists. This rule would reach situations in which damages would be much greater than fairness would dictate, not only in relation to size of consideration received but also with respect to seriousness of breach. The suggestion was advanced earlier in this article that the term "disproportionate" in section 351(3) could be so interpreted.<sup>187</sup> At least one state legislature has enacted a statute that prohibits awarding of damages (in contract as well as other disputes) that are "unconscionable and grossly oppressive [and] contrary to justice" and requires instead that "no more than reasonable damages can be recovered."<sup>188</sup> Courts currently seek to avoid harshness of remedy by making contracts divisible when the result is to create several smaller contracts, only some of which are considered breached.<sup>189</sup> The breaching party consequently is liable for damages, but he is not deprived of receiving the other party's performance for the portions of the contract not breached. Another means of ameliorating unfairness of remedy consists of declaring a breach not material, so as not to deprive the breaching party of receipt of all further performance.<sup>190</sup> Other examples of methods of avoiding unfairly harsh

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185 See, e.g., *Campbell Soup Co. v. Wentz*, 172 F.2d 80, 84 (3d Cir. 1948) (refusing to require specific performance of "too hard a bargain for a court of conscience to assist"); *McKinnon v. Benedict*, 38 Wis. 2d 607, 621, 157 N.W.2d 665, 671 (1968) (refusing to require specific performance of a contract when the "inadequacy of consideration" was "so gross as to be unconscionable.").

186 See *supra* note 50.

187 See text accompanying *supra* notes 47-50.

188 OKLA. STAT. ANN. tit. 23, § 97 (1986). The statute provides: "Damages must, in all cases, be reasonable, and where an obligation of any kind appears to create a right to unconscionable and grossly oppressive damages, contrary to substantial justice, no more than reasonable damages can be recovered." This statute as it then existed was cited in *Peevyhouse*, which is discussed in the text accompanying *supra* notes 131-34.

189 See, e.g., *Lowy v. United Pac. Ins. Co.*, 67 Cal. 2d 87, 429 P.2d 577 (1967); *John v. United Advertising, Inc.* 165 Colo. 193, 439 P.2d 53 (1968); *Gill v. Johnstown Lumber Co.*, 151 Pa. 534, 25 A. 120 (1892).

190 See, e.g., *Riess v. Murchison*, 503 F.2d 999 (9th Cir. 1974), *cert. denied*, 420 U.S. 993 (1975); *Walker & Co. v. Harrison*, 347 Mich. 630, 81 N.W.2d 352 (1957).

remedies include interpreting language as a promise<sup>191</sup> or as an evidentiary requirement<sup>192</sup> rather than as an express condition, in order not to excuse an aggrieved party from all further performance when the promise is not fulfilled or the evidence not provided.

When a court grants restitution to a plaintiff who has breached an enforceable contract,<sup>193</sup> this remedy, recognized as contractual,<sup>194</sup> limits on the ground of fairness the forfeiture that the breaching party would otherwise suffer and thus combats unfairness. The Uniform Commercial Code permits a portion of the contract price to be reclaimed by a breaching buyer who has not received the purchased goods.<sup>195</sup> Under the doctrine of substantial performance, minor breach of a construction contract results only in deduction of damages from the contract price, rather than excusing the aggrieved party from paying the contract price;<sup>196</sup> disproportion between the size of the breach and a remedy consisting of loss of the entire contract price would be unconscionable. Legislation that proscribes forfeiture in carefully delineated instances<sup>197</sup> also prevents unconscionability of remedy. In addition, refusal to enforce a liquidated damage clause in a contract on the ground that the amount provided is unfairly large in comparison with projected<sup>198</sup> or actual<sup>199</sup> loss can be seen as avoidance of unconscionability of remedy.

Furthermore, courts exercising discretion in choosing remedies in breach of contract actions sounding in equity, such as requests for specific performance,<sup>200</sup> include among their goals the prevention of unconscionability of remedy. Although both the Uniform Commercial Code<sup>201</sup> and the *Restatement Second*<sup>202</sup> authorize a court to refuse enforcement of unconscionable contracts or contract terms as a matter of law, the word "may" in both the Code and the *Restatement* permits the court to act at its discretion. Both provisions expressly authorize a court "to avoid any unconscionable result."<sup>203</sup>

191 See, e.g., *Byler v. Great Am. Ins. Co.*, 395 F.2d 273, 276-77 (10th Cir. 1968); *Thos. J. Dyer Co. v. Bishop Int'l. Eng'g. Co.*, 303 F.2d 655, 661 (6th Cir. 1962); *Peacock Constr. Co. v. Modern Air Conditioning, Inc.*, 353 So. 2d 840, 842-43 (Fla. 1977).

192 See, e.g., *Ferguson v. Phoenix Assurance Co.*, 189 Kan. 459, 370 P.2d 379 (1962).

193 See, e.g., *Maxey v. Glindmeyer*, 379 So. 2d 297 (Miss. 1980); *Britton v. Turner*, 6 N.H. 481 (1834).

194 See *Perillo*, *supra* note 134, at 1214.

195 U.C.C. § 2-718(2)(b) permits the breaching buyer to recover the excess of money paid over "twenty percent of the value of the total performance for which the buyer is obligated under the contract or \$500, whichever is smaller."

196 See, e.g., *Jacob & Youngs v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921) (Cardozo, C. J.); *Dixon v. Nelson*, 79 S.D. 44, 107 N.W.2d 505 (1961); *Plante v. Jacobs*, 10 Wis. 2d 567, 103 N.W.2d 296 (1960).

197 See, e.g., CAL. CIV. CODE. § 3275 (West 1970), cited in *Holiday Inns of America, Inc. v. Knight*, 70 Cal. 2d 327, 450 P.2d 42, 74 Cal. Rptr. 722 (1969) (Traynor, J.).

198 See, e.g., *Rye v. Public Serv. Mut. Ins. Co.*, 34 N.Y.2d 470, 315 N.E.2d 458, 358 N.Y.S.2d 391 (1974); *Seeman v. Biemann*, 108 Wis. 365, 84 N.W. 490 (1900).

199 U.C.C. § 2-718(1) provides that the reasonableness of the amount of liquidated damages should be assessed "in the light of the anticipated or actual harm caused by the breach."

200 See, e.g., *Grayson-Robinson Stores, Inc. v. Iris Constr. Corp.*, 8 N.Y.2d 133, 168 N.E.2d 377, 202 N.Y.S.2d 303 (1960); *McKinnon v. Benedict*, 38 Wis.2d 607, 157 N.W.2d 665 (1968).

201 U.C.C. § 2-302.

202 RESTATEMENT SECOND, *supra* note 3, § 208.

203 U.C.C. § 2-302; RESTATEMENT SECOND, *supra* note 3, § 208.

Courts have excused promisors from their contractual obligations on the ground of unilateral mistake in formation of the contract when enforcement would have produced results which these courts deemed unconscionable.<sup>204</sup> In one such case the court stated, "[L]ittle is to be gained if a [promisor] is forced to perform a contract at an extravagant loss or the risk of possible bankruptcy."<sup>205</sup> Section 153 of the *Restatement Second* expressly provides that when enforcement of a contract would be "unconscionable" in view of a promisor's unilateral mistake, the promisor's performance can be excused.<sup>206</sup> The Comment to the section notes a trend toward this view.<sup>207</sup> In most instances, the required unconscionability of enforcement would result from extreme disproportion, with regard to either consideration received by the breaching party or harm caused by his mistake. This provision of the *Restatement Second* illustrates the interrelationship of the concepts of disproportion and unconscionability of remedy.

## V. Conclusion

The influence of section 351(3) has extended beyond the borders of what traditionally is viewed as contract law. It has directly affected the drafting of the Principles of Corporate Governance currently under consideration for adoption by the American Law Institute.<sup>208</sup> A Reporter's Note to the Principles states that contract rather than tort law may appropriately govern the issue of corporate directors' and officers' liability for breach of the duty of due care, in view of the fact that "the relationship between a director or officer and the corporation is consensual in nature."<sup>209</sup> The Note then quotes section 351(3) and refers to the Comment to section 351(3).<sup>210</sup> The proposed black letter section 7.17 of the Principles expressly limits "[d]amages for [c]ertain [v]iolations of the [d]uty of [c]are" committed under specified conditions to "an amount that is not disproportionate to the compensation received by the director or officer for serving the corporation during the year of the violation."<sup>211</sup>

The limiting of contractual liability in another area of rapidly changing law is exemplified in a proposed amendment to the Uniform Commercial Code, Article 4A - Wire Transfers.<sup>212</sup> The draft most recently prepared by the National Conference of Commissioners on Uniform State Laws precludes liability of a destination bank for consequential

204 See, e.g., *Elsinore Union Elementary School Dist. v. Kastorff*, 54 Cal. 2d 380, 386-89, 353 P.2d 713, 717-19, 6 Cal. Rptr. 1, 5-7 (1960); *Balaban-Gordon Co. v. Brighton Sewer District No. 2*, 41 A.D.2d 246, 247, 342 N.Y.S.2d 435, 437 (1973).

205 *Balaban-Gordon Co.*, 41 A.D.2d at 251, 342 N.Y.S.2d at 441 (1973).

206 *RESTATEMENT SECOND*, *supra* note 3, § 153.

207 Comment *a* states: "There has . . . been a growing willingness to allow avoidance where the consequences of the mistake are so grave that enforcement of the contract would be unconscionable."

208 *PRINCIPLES OF CORPORATE GOVERNANCE* § 7.17 (Tent. Draft No. 7, 1987).

209 *Id.*, § 7.17 note, at 63.

210 *Id.* § 7.17 note, at 63-64.

211 *Id.* at § 7.17.

212 *UNIFORM COMMERCIAL CODE* § 4A-307 (Draft, Article 4A - Wire Transfers, Measure of Damages for Breach of Obligations Created by Acceptance and Breach of Contract to Accept Transfer Order, 1987).

damages if it breaches its contractual duty to a beneficiary by failing to make payment to him or "wrongfully revokes a right of the beneficiary to withdraw funds."<sup>213</sup> This rule is more stringent than the disproportion test or the requirement of lack of foreseeability, because it excludes, rather than limits, consequential damages.<sup>214</sup>

In sum, this article has demonstrated that courts and legislatures have limited disproportionate, unconscionable remedies, both overtly and covertly, in most of the circumstances encompassed by section 351(3). This is true whether the scope of section 351(3) be interpreted to include only consequential damages or, in addition, general damages. These courts and legislatures have apparently been pursuing a policy of preventing extreme unfairness, or unconscionability of remedy. Section 351(3) is therefore innovative in its candor rather than in the concept it applies.

In contrast with the foreseeability requirement, which it supplements and enhances, section 351(3) offers precision of application, thus increasing predictability and encouraging the making of contracts. Judicial efficiency also is increased by the clarity and precision of this standard. Further, the flexibility of section 351(3) permits courts to accomplish justice more fully.

Courts can and should invoke either the carefully and admirably crafted section 351(3) or the more newly identified concept of unconscionability of remedy. They can do this with confidence that they are pursuing policies and goals that have been viewed as significant since at least 1854, when *Hadley v. Baxendale*<sup>215</sup> was decided, policies and goals that are indispensable to the wise, fair, and effective administration of the rule of law.

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<sup>213</sup> *Id.*

<sup>214</sup> Under the proposed legislation, consequential damages are payable only if a destination bank refuses to pay the beneficiary within a reasonable time of a demand by the latter, and then only when such refusal to pay was not caused by "a reasonable doubt" as to the beneficiary's right to payment. *Id.*

<sup>215</sup> 156 Eng. Rep. 145 (1854).